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Competition and Inflation – Note by Spain

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This document reproduces a written contribution from Spain submitted for Item 12 of the 139th OECD Competition Committee meeting on 29-30 November 2022.

More documents related to this discussion can be found at
www.oecd.org/competition/competition-and-inflation.htm

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1. Key aspects of inflation regarding competition policy

1. Competition policy is expected to have an impact on prices, both in its antitrust and advocacy facets. Both seek to attack low levels of competition in certain sectors, which are often associated with unduly high price levels. The activities of competition policy will have as a plausible effect, ceteris paribus, lower prices in the sectors intervened in the medium/long term.

2. Inflation, however, is by definition a broader price phenomenon. According to the definition of the European Central Bank[1], inflation is "a broad increase in the prices of goods and services, not just of individual items". This definition highlights two key aspects of this phenomenon:

- It is a macroeconomic issue, affecting the whole economy since it covers the simultaneous evolution of prices of a representative basket of goods and services.
- It is a dynamic issue, as it involves persistent increases in prices, although some specific episodes of strong rises, such as the current one, cannot be ruled out.

3. In contrast, the two key aspects that characterize the competition policy actions that would cause these lower prices would be:

- They have a microeconomic nature, as they are initially limited to specific sectors or markets, and
- They have a rather static, structural nature, since they would achieve a one-off effect on prices, which would continue *ceteris paribus* in the medium and long term.

4. This is in part due to the standard analytical framework used by the competition authorities, based on a microeconomic (single-market) and static standpoint. This is the predominant approach in the theory of Industrial organization, the main tool of economic theory used by competition policy. Therefore, some caution is required when examining the possible links between competition and inflation (seen as an aggregate, dynamic phenomenon).

5. However, this restricted scope of the effects of competition policy, both spatially and temporally, could be exceeded in some cases, thus bringing it closer to the scope of inflation. From the spatial point of view (the affected markets), the competition policy activities could spill over other related markets, if the markets concerned are sufficiently relevant or interrelated with the rest of the economy, such as energy markets or those of other production factors. In this sense, the intervention of competition authorities would be able to modify the price level in sectors with an important weight in the price indices. From the temporary point of view, the effects of competition policy activities could be extended over time, even leading to continuous reductions in the long term. This can be accomplished if such competition policy activities manage to modify the structural features of the

[1] European Central Bank (2022), "What is inflation?", https://www.ecb.europa.eu/ecb/educational/explainers/tell-me-more/html/what_is_inflation.en.html

intervened sector, in such a way that it allows permanently a more competitive behavior among industry players.

2. Competition and its effects on price levels and inflation

6. Therefore, competition policy measures that promote more efficient and competitive markets will affect the functioning of economies, including the price level and, in certain scenarios, its variation over time, that is to say, inflation.

7. Among the benefits usually highlighted in efficient and competitive markets are price reductions, quality improvements, increases in the variety of supply and greater accessibility to different products. Greater competition, among other things, makes it possible to reduce the higher prices caused by market power and, in addition, can encourage companies to be more efficient and innovative to improve their products. In this line, the academic literature presents numerous examples of how competition and efficient regulation can lead to lower prices. It is worth highlighting the empirical study carried out by the IMF (Bouis, Duval and Eugster, 2016)[2], who, using data for the period 1985-2015 in 26 OECD countries, calculate that the prices of five highly relevant sectors (electricity and gas, telecommunications, land transport, air transport and postal services) fell from average 12% in five years after the introduction of reforms to remove entry barriers. The CNMC has had the opportunity to analyze these key sectors to promote potentially pro-competitive reforms, such as the automotive fuel market, with a series of market studies in 2009[3], 2012[4], 2015[5], 2016[6] and 2019[7], the latter examining the impact of the entry of new automatic gas stations in the Region of Madrid and concluding that more competition caused an actual reduction in prices. The passenger transport markets have also been explored by the CNMC, both the rail transport service[8] and the intercity bus transport service[9], and the analysis suggests too that pro-competitive reforms can have positive effects on the price level of these markets.

8. The interplay between competition and inflation has proven more difficult to ascertain. The works of Przybyla and Roma (2005)[10] and Janger and Schmidt-Dengler

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[2] Bouis, R., Duval, R. A., & Eugster, J. (2016). "Product Market Deregulation and Growth", IMF Working Papers, 2016(114), A001 (https://www.elibrary.imf.org/view/journals/001/2016/114/article-A001-en.xml).

[3] Report on competition in the market of automotive fuel in Spain (2009), E-2009-01.

[4] Report on the market of automotive fuel in Spain at the request of the State Secretariat for Economy and Business Support (2012), E-2012-03.

[5] Market study on the wholesale automotive fuel market in Spain (2015), E/CNMC/002/2015.

[6] Report (PRO) on the regulation of automated service stations in Spain (2016), PRO/CNMC/002/16.

[7] Analysis of the competitive impact of the entry of unmanned petrol stations in the retail fuel market (2019), E/CNMC/005/19.

[8] Market study on the liberalization of passenger transport services by rail (2019), E/CNMC/004/19.

[9] Market study on the intercity passenger transport services by bus (2022), E/CNMC/006/19.

[10] Przybyla, Marcin; Roma, Moreno (2005): "Does product market competition reduce inflation? Evidence from EU countries and sectors", ECB Working Paper, No. 453, European Central Bank (ECB), Frankfurt a. M.

(2010)[11] examine this issue in the EU and find a significant and inverse relationship between competition and inflation, particularly in the short and medium term, in such a way that higher levels of competition moderate inflation. These analyses indicate that one of the determinants of how competition and efficient regulation affect inflation has to do with the price formation process. Among other things, they will affect the so-called 'second round effects', which are cascading increases in prices and wages resulting from an initial rise in the price level. The literature on this subject indicates that these second-round effects and, in general, the ability to efficiently adapt to an economic shock, will be affected by the structure of the economies, which includes the degree of competition, flexibility and efficiency. For example, Correa-López et al. (2010)[12] analyze 20 OECD countries for the period 1961 to 2006 and find that, in those countries having lower barriers to competition, inflation responds less to changes in the prices of imported goods, which they attribute to the fact that, in competitive environments, companies are more likely to adjust their margins rather than raise their prices.

9. In addition, competition can be increased both by pro-competitive reforms at the domestic level and by opening up to foreign competition, for example, through tariff reductions or trade agreements. The CNMC (CNMC, 2017)[13] noted the potential beneficial effects of boosted international competition. Among the empirical studies of the former stands out the analysis undertaken by the ECB (Draghi, 2015)[14] for the euro area countries, showing a disinflationary effect of up to one percentage point annually, in addition to raising growth to one and a half points per year. Regarding the latter, the empirical literature has found that trade openness can help fight inflation, largely due to its pro-competitive impact. For example, Guerrieri et al. (2010)[15] found that half of the reduction in inflation experienced in the US in the 1990s compared to the previous period (a reduction of approximately 2% per year), was due to international competition, while Chen et al. (2004)[16] estimate that the rise in foreign competition had a significant disinflationary effect in the EU between 1988 and 2000.

3. Competition policy as an anti-inflationary tool

10. In most advanced economies, it is the monetary authorities (Central banks) who are in charge of achieving price stability objectives, quantified through some measure of inflation over some time horizon. This is quite sensible as the tools at their disposal can affect the whole range of prices with the shortest lag.

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[11] Janger, J. & Schmidt-Dengler, P. (2010). "The Relationship between Competition and Inflation," Monetary Policy & the Economy, Oesterreichische Nationalbank (Austrian Central Bank).

[12] Correa-López, M., García-Serrador, A., & Mingorance-Arnáiz, C. (2014), "Product market competition, monetary policy regimes and inflation dynamics: Evidence from a panel of OECD countries". Oxford Bulletin of Economics and Statistics, 76(4), 484-509.

[13] Analysis on the benefits from international trade and their implications on competition (2017), PRO/CNMC/002/2017.

[14] Draghi, M. (2015). "Structural reforms, inflation and monetary policy". Forum on Central Banking. https://www.ecb.europa.eu/press/key/date/2015/html/sp150522.en.html

[15] Guerrieri, L., Gust, C., & López-Salido, J. D. (2010). "International competition and inflation: a New Keynesian perspective". American Economic Journal: Macroeconomics, 2(4), 247-80.

[16] Chen, N., Imbs, J. M., & Scott, A. (2004). "Competition, globalization and the decline of inflation". Available at SSRN: https://ssrn.com/abstract=639188

11. Inflation can originate from monetary factors (related to the quantity of money and levels of interest rates) or from factors related to the real economy. When the origin of inflation lies in the monetary realm, the Central Bank is always the best placed to control inflation through restrictive monetary policies. And even when these pressures come from other type of (demand or supply) shocks, monetary policy is usually an effective tool to target inflation.

12. Competition policy can also help to reduce inflation pressures, although its effects may be felt more in the medium and long term. Competition policy can lead to a permanent effort across the entire business cycle, by delivering more flexible, efficient markets which can respond quickly to any kind of inflationary shocks and, equally important, to any anti-inflationary policy implemented to tackle such shocks. In this respect, antitrust policy in the form of vigorous merger control and restriction of anticompetitive conducts, as well as competition advocacy policy through the promotion of efficient economic regulation that eliminates artificial barriers to competition, could enable a prompt, efficient adjustment of the whole economy, thereby enabling a swifter restoration of the objective of price stability.

4. Competition enforcement in times of high inflation

13. Competition policy can be an effective tool to reduce price pressures in markets where prices are rising rapidly, for whatever reasons, as firms can be tempted to collude to raise prices under the cover of the general trend (the so called “inflation washing”), expecting their agreement to attract less notice than at other times.

14. On the other hand, at times of demand or supply shocks that cause supply shortages and a steep rise in prices in specific product markets, it could be necessary for competition authorities to monitor closely the behaviour of firms. However, when this happens in relatively small markets, or in sectors with few links with downward markets, as was the case with health products during the first months of the pandemic (e.g., masks and respirators), it is highly unlikely that this process will have inflationary effects in the economy.